BEFORE THE

SOUTH CAROLINA PUBLIC SERVICE COMMISSION

In the Matter of:		
South Carolina Electric and Gas Company's	)	
Application for an Increase in its	)	**Docket No. 2004-178-E**
Electric Rates and Charges	)	

Brief
Of The Department of the Navy

DEPARTMENT OF THE NAVY,
Utility Rates Analysis and Studies Office

November 30, 2004

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POST HEARING BRIEF OF
THE DEPARTMENT OF THE NAVY

Docket No. 2004-178-E

I. INTRODUCTION

The United States Department of the Navy representing the consumer's interest of the Department of Defense presented the testimony of one witness, Ralph C. Smith, a certified public accountant and senior regulatory consultant with the firm Larkin & Associates PLLC. Mr. Smith's appendix of resume and qualifications was marked as Hearing Exhibit 30 as was entered into the record. Mr. Smith's Exhibit __(RCS-1) which presented the adjustments he is recommending be made to SCE&G's proposed rate base and adjusted net operating income was marked as Hearing Exhibit 29 and entered into the record. Hearing Exhibit 29 has six Schedules, one schedule for each adjustment.

Mr. Smith's testimony addressed these issues:

- The Company's request for retail rate recovery of GridSouth costs;
- An adjustment to reflect the 12 month average of Fossil Fuel Inventory in rate base;
- The Company's request to amortize into operating expenses an accrued liability for postemployment post-retirement benefits it recorded pursuant to Statement of Financial Accounting Standards ("FAS") No. 112;
- An adjustment to annualize test year operating expense in Account 924, Administrative and General Expense-Property Insurance;

- The Company's request for additional expense for new internal positions anticipated to be needed for compliance with new North America Electric Reliability Council (NERC) standards; and
- An adjustment for a levelized allowance for Other Major Maintenance Expense.

Other parties, such as Commission Staff, Consumer Advocate, or other interveners have also raised issues and presented testimony and from that testimony of other parties other issues of significance to the Navy have come to light.

II. SETTLEMENT PROPOSAL

After a preliminary discussion with the Navy, where the Navy agreed that settlement was a possibility and further discussions would be fruitful, the Company and the staff entered into intensive discussions limited to those two parties, signed off on their settlement agreement, and then presented the settlement to the other parties as a final document. Because of the way the settlement came about, the concerns of the Navy were not addressed. However, with the next contact from SCE&G we were presented with a completed settlement with staff that was final and unalterable. The Company made repeated offers to allow the Navy to join in the settlement after the fact, representing that any and all savings the Navy could have possibly enjoyed were already included in the two party agreement with staff. The Navy urges the Commission to consider making a determination on each of the litigated issues presented at the hearing,. However, the Navy does agree that the overall result reached in the settlement of a $51 million increase is more reasonable than the Company's original request.

III. DISCUSSION AND ANALYSIS

1. The Company's request for retail rate recovery of GridSouth costs

GridSouth is the name of the prospective regional transmission organization ("RTO") that was in the process of being formed by SCE&G, Duke Power and Carolina Power and Light Company in response to directives issued by the Federal Energy Regulatory Commission ("FERC") in Order 2000.

The GridSouth project was suspended by SCE&G management following an order issued by FERC July 12, 2001, Carolina Power and Light Co. et al, 96 FERC 61,067 (2001). SCE&G's response to Consumer Advocate interrogatory 1-34 states that: "GridSouth never existed as an entity. No agreements between SCE&G and GridSouth exist." Additionally, the Company's response to Consumer Advocate interrogatory 1-31 states that the GridSouth board of directors was never seated.

As explained in the direct testimony of SCE&G witness Carlette Walker, the Company proposes to amortize its investment in the GridSouth project over five years with a resulting increase in annual O&M expense of $2,819,193 and to include in rate base an amount of $7,047,982 representing the average amount of investment which will be reflected on the Company's books during the five year amortization period. SCE&G asserts the costs were prudent and only 6% of GridSouth costs should be allocated to the FERC jurisdiction because only 6% of the Company's business is wholesale. TR 1631:1633.

SCE&G must first seek recovery at FERC to confirm such expenditures met FERC prudence standards. If FERC will not allow recovery of these expenditures in their jurisdiction, then South Carolina retail ratepayers should not bear this burden. The supposition by SCE&G that more than 90% of these costs will be allocated to the retail jurisdiction is neither known nor measurable because they have not sought recovery from the FERC. In fact, the entire purpose of

GridSouth was to provide for a robust wholesale market, while SCE&G transmission assets serve both retail and wholesale customers.

As explained in the testimony of Navy witness Ralph Smith, GridSouth costs incurred by SCE&G should not be allowed in rates at this time for a number of reasons.

- The GridSouth expenses are non-recurring because SCE&G does not attempt to form more RTOs on a regular recurring basis.
- These costs do not meet the traditional standards for deferred cost recovery.
- GridSouth does not meet the "used and useful" standard.
- There is no future benefit to SCE&G ratepayers from GridSouth.
- The FERC was the cause of the Company incurring cost for GridSouth, and FERC has not approved inclusion in wholesale rates of the costs incurred by the Company related to the GridSouth RTO. As SCE&G explained in the response to Navy data request 1-7, "The Company has not sought approval of the FERC to include in wholesale rates the costs related to GridSouth."
- GridSouth costs were addressed in SCE&G's last rate case, and the Commission's discussion of this issue is contained on pages 14-17 of its January 13, 2003 Order No. 2003-238. Similar to the Commission's evaluation of this issue in that case, a number of the same concerns are also applicable in the current case and should produce the same conclusion:
    - Most of the costs were incurred before the test year.
    - The Company has not met its burden for recovery at this time.
    - GridSouth was not operational during the test year and should not be considered used and useful during that time.
    - FERC has made no determination of how it will treat GridSouth expenditures at the wholesale level.

For all of these reasons, the Commission should reject SCE&G's proposal to have South Carolina jurisdictional customers pay for costs and expenses related to GridSouth that were generated because of FERC actions, but not included in FERC tariffs.

During the hearings, Mr. Smith was asked by Commissioner Clyburn what other state regulatory commissions have done concerning rate recovery of costs associated with RTOs that never became operational. (Tr. 1209) Mr. Smith was also asked by SCE&G counsel whether

Georgia Power Company had requested in its rate case before the Georgia Public Service Commission costs for the SeTrans RTO. (Tr. 1211) The SeTrans RTO, like GridSouth, never became operational. Based on information from the Georgia PSC Commission staff, which is also readily available on the GPSC web site, we now are able to state with certainty that Georgia Power Company did initially include costs for the SeTrans RTO in its current rate filing, GPSC Docket No. 18300-U, but subsequently withdrew such request and specifically agreed to remove $5,942,611 of cost for an RTO system operator after being questioned by the GPSC Staff about such cost.[1]

Navy witness Smith's recommendation that SCE&G's GridSouth costs be removed in the current rate case is also fully consistent with the Commission's ruling concerning SCE&G's request for retail rate inclusion of GridSouth costs in its last rate case. In its last rate case, Docket No. 2002-223-E, SCE&G had requested retail rate inclusion of GridSouth costs. The Commission's discussion of this issue is contained on pages 14-17 of its January 13, 2003 Order No. 2003-238. Similar to the Commission's evaluation of this issue in Docket No. 2002-223-E, these concerns also are applicable in the current case and should produce the same conclusion:

- Most of the costs were incurred before the test year.
- The Company has not met its burden for recovery at this time.
- GridSouth was not operational during the test year and should not be considered used and useful during that time.
- FERC has made no determination of how it will treat GridSouth expenditures at the wholesale level.

[1] See cross examination of Georgia Power Company witness Ron Hinson by PSC Counsel Dan Walsh in the 9/20/04 transcript from GPSC Docket 18300-U. Such transcript is available on the GPSC web site under the Georgia Power Company rate case, Docket 18300-U.

These same factors that were applicable in Docket No. 2002-223-E concerning this issue continue to be applicable in the current case.

Consumer Advocate Witness Glenn Watkins response to Commissioner Howard's questions (Tr. 1035:1036) goes to the heart of the matter.

> *"As I testified in the 2002 case, I recognize there was some pressure put on the utilities to get the ball rolling and let's get going with this RTO. The biggest problems I had was -- and again, in all fairness, FERC and Mr. Woods were going about 40 directions in 48 days. But to jump in with both feet and spend as much money as they did in that short amount of time, and then not be able to sit down and form something with the Southern company or the other utilities, or consider other alternatives, and at the same time form a for-profit RTO as opposed to a break-even RTO, and not provide any information as to, justification as to why they spent the level of funds that they did, I felt that until they do, the retail ratepayer should not be asked to pay for those costs."*
>
> (Watkins Tr. 1036:L5-18)

2. Fossil Fuel Inventory

On Company Exhibit D-VI, page 1 of 2, line 2, SCE&G shows $26.945 million for Fossil Fuel Inventory, based an average year balances, and proposed to increase this by $23.340 million in its proposed Adjustment No. 19 to Adjust Fossil Fuel Inventory. SCE&G requested that $50.285 million of Fossil Fuel Inventory be included in rate base, as shown on Exhibit D-VI, page 1 of 2, line 3, of which $46.806 million is allocated to retail. SCE&G's Adjustment No. 19 reflected increases in the average coal quantity and the average cost of coal. On August 27, 2004, SCE&G filed a correction to its Adjustment No. 19, revising its October 2003 actual coal inventory amount and also revising its requested increase to $13.257 million and the total requested fuel inventory to $40.635 million. With this revision, the retail jurisdictional increase requested by SCE&G is $12.339 million and brings the retail Fossil Fuel Inventory that SCE&G proposes to $37.823 million.

In prior SCE&G rate cases, a 12-month average was used to determine SCE&G's Materials and Supplies balance, which includes Fossil Fuel Inventory. Because the balances for each component of Fossil Fuel Inventory, as well as the total, fluctuate from month to month, it is appropriate and more representative of normal experience to utilize an average balance for determining the rate base amount.

In a revision filed August 27, 2004, SCE&G revised its October 2003 actual coal inventory amount, which increased the test year average coal inventory to $22,220,063. This is shown on Hearing Exhibit 29, Schedule 2, page 2. As shown there, based on the information provided in SCE&G's Response to Staff information data request 1-46, this represents a 38-days supply based on average forecasted burn and a 30-days supply based on maximum drawdown.

The Company should not be allowed to earn a rate base return on a coal inventory that it did not actually have during the test year. Moreover, the test year average, which represents a 38-days supply based on average forecasted burn and 30-days supply based on maximum drawdown, is sufficient to meet the needs of SCE&G. Consequently, there is no need to adjust the average test year quantity of coal inventory.

The fossil fuel inventory should not be adjusted for fluctuations in the unit price of coal that may have occurred subsequent to the test year. The higher per-ton prices proposed by SCE&G were not effective during the test year, lack support, and should not be used.

SCE&G's actual March 31, 2004 coal inventory was $15,923,397, as shown on the Company's response to Staff data request 1-62. The recommendation of Navy witness Smith of using the average test year coal inventory, as corrected by SCE&G, of $22,220,063 is $6,296,666, or 39.5 percent, higher than this end-of-test-year balance. The actual test year average for Fossil Fuel Inventory without adjustment for higher coal inventory quantities or coal cost increases that were not experienced during the test year, as shown on Hearing Exhibit 29, Schedule 2, should be used as the proper amount of coal inventory to be included in SCE&G's rate base for the test year.

3. Long-Term Disability (FAS 112) Amortization

As described in SCE&G witness Walker's testimony at pages 12-13, in its Adjustment No. 9, SCE&G proposes to amortize over five years an $8.3 million liability that it accrued pursuant to Statement of Financial Account Standards No. 112 ("FAS 112") associated with its long-term disability program. SCE&G deferred these costs in a regulatory asset account and its proposed amortization would increase test year O&M expenses by $1,656,094.

FAS 112 is an accounting standard that was issued in November 1992 and became applicable for financial reporting purposes in 1994. FAS 112 covers benefits provided by the employer to former or inactive employees after employment but before retirement, such an employer's liability for long-term disability payments. For financial reporting purposes, FAS 112 required companies to recognize the cumulative effect of switching to the accrual method of accounting for post employment benefits, or their post employment benefit obligation, in 1994; in other words, 1994 was the year of initial adoption required by FAS 112.

Furthermore, unlike FAS 106 which applied to post retirement health benefits and which provided for amortization of the accumulated benefit obligation over an amortization period as long as 20 years, under FAS 112, the post employment benefit obligation for benefits such as long-term disability must be recognized in its entirety at the date of adoption. There is no provision for a future amortization under FAS 112 (Walker Tr. 775:L7-10).

In response to Staff information request 1-52, SCE&G shows that it has recorded equal and offsetting balances of $11.004 million for Long Term Disability in Other Regulatory Assets and Other Deferred Credits on its books. The Company has no accounting order or other authorization from the Commission to treat the FAS 112 expense as a regulatory asset. Nor has SCE&G demonstrated how much, if any, of the $11.004 million was really an expense that was incurred during the test year, as opposed to the cumulative effect of adopting FAS 112, a large portion of which would likely be attributable to prior years when employees became disabled and commenced receiving long-term disability payments, and which SCE&G probably should have recorded in prior years as the expense was incurred. SCE&G's response to Staff data request 1-85 did not identify FAS 112 as an accounting pronouncement which was implemented by the Company during the test year.

The cross examination of SCE&G witness Carlette Walker concerning this issue confirms that SCE&G's proposal to include a FAS 112 accrual amortization in the current test year is fatally flawed. SCE&G has included both pay as you go expenses and amortization expense of accrued liability. (Walker Tr. 771-775) This mix and match methodology assures duplicate recovery of expenses.

It is generally <u>not</u> appropriate to include in the test year, expenses which are attributable to prior years and/or which should have been accrued in prior years. Rate inclusion of a FAS 112 accrual amount is not appropriate because FAS 112 was required to be adopted in 1994, and we are now ten years beyond that point. In its filing, SCE&G already included long-term disability expense in test year operating expenses, before its request for additional expense for

FAS 112 in Adjustment No. 9. Also, SCE&G has not supported its proposed amortization period.

Consequently, for all of the reasons explained in the testimony of Navy witness Ralph Smith and above, SCE&G's proposal to increase test year expense by $1.656 million for a FAS 112 amortization in its Adjustment No. 9 should be rejected.

4. Annualize Account 924, A&G Expense-Property Insurance

Navy witness Ralph Smith recommended an uncontested adjustment to annualize the test year expense in Account 924, Administrative and General Expense – Property Insurance to test year-end levels. During the test year SCE&G recorded $3,325,963 expense in Account 924. Mr. Smith's analysis as shown on Hearing Exhibit 29, Schedule 4, page 2, demonstrates on average, the monthly amounts have decreased.

This known and measurable expense decrease which occurred within the test year should be reflected for ratemaking purposes. Annualizing the March 2004 expense produces an annual expense allowance that is $154,810 less than the recorded test year amount. The decrease to retail electric expense is $148,308. This adjustment was not challenged by SCE&G in its rebuttal and was not contested by any party to the proceeding. Therefore, this adjustment to reflect known annualized property insurance expense should be adopted.

5. New Internal Positions for Compliance with New NERC Standards

SCE&G included in its filing, as part of its Adjustment 13C, a projected expense increase for eight new internal positions and benefits that SCE&G projects would be needed for compliance with new NERC Standards. However, SCE&G has not supported its proposed use of average annual salary amounts for new employees as well as hiring eight additional positions. Consequently, this SCE&G proposed adjustment does not meet the known and measurable standard and should therefore be removed. SCE&G's proposed pro forma addition to test year expense should be reduced by $870,000, and its proposed retail electric expense by $818,844.

6. Levelized Allowance for Other Major Maintenance Expense

In its adjustment no. 5, SCE&G proposes a $5.412 million, or 177 percent, increase to test year expense for a levelized allowance of future projected major turbine maintenance expense for an eight-year forecast period consisting of years 2005 through 2012. I recommend two adjustments to this SCE&G proposal:

(1) Reflect current value dollar amounts of the future year expenditures used by SCE&G in its proposed Adjustment No. 5; and

(2) Reflect five years as the initial "trial" period for the levelization, rather than the eight years proposed by SCE&G.

The five-year period 2005 through 2009 includes substantial maintenance at Urquhart and Jasper, and should therefore be fairly representative of high and low years. Besides, using a shorter initial levelization period, such as five-years as opposed to SCE&G's proposed eight years helps alleviate the concern that the Company's current estimates of future maintenance may be less reliable as the projection period is extended further out into the future.

Additionally, because this levelization proposal is a new program, the reliability of SCE&G's projected maintenance estimates should be subject to review in SCE&G's next rate case. Navy witness Smith also recommend that SCE&G report to the Commission on its actual versus projected expenditures, and refund any over-collected balance at the end of the five-year "trial" period to ratepayers.

When asked by Commissioner Hamilton during the hearings about the Staff's proposed adjustment for the levelized allowance for other major maintenance expense, Mr. Smith agreed that the treatment recommended by Staff represented a reasonable treatment of the issue and a good compromise. (Smith Tr. 1206-1207).

Summary of Adjustments and Recommendations

Navy witness Ralph Smith recommended that the Commission incorporate the following adjustments and provisions into its final order in this proceeding:

1. Reject SCE&G's proposal to have South Carolina jurisdictional customers pay for costs and expenses related to GridSouth generated because of FERC actions, but not included in FERC tariffs.
2. Reduce SCE&G's August 27, 2004 updated Rate Base by $13.257 million to recognize test year average fuel inventory balances.
3. Reject SCE&G's proposal to increase test year O&M expense by $1.658 million for the amortization of a long-term disability accrual relating to the implementation of FAS 112.
4. Reduce test year expense by $154,810 to annualize the expense in Account 924, Administrative and General Expense – Property Insurance to the end-of-test year level.
5. Reduce test year expense by $870,000 for 8 new positions proposed by SCE&G for compliance with new North American Electric Reliability Council Standards because SCE&G's Adjustment 13C does not meet the

known and measurable standard with respect to the actual salary costs or the actual hiring of the proposed new employees.

6. Reduce the pro forma expense proposed by SCE&G for a levelized recovery program for Other Major Maintenance Expense by $2,855,902 to reflect the application of a discount rate for future year projected amounts and to reflect a five-year period, rather than the eight-year period proposed by SCE&G.

7. If the Commission adopts a levelized recovery program for Other Major Maintenance Expense, it should require SCE&G to report on its actual versus projected maintenance expenses covered under the program, and refund any over-collected balance at the end of the five-year "trial" period to ratepayers. The Staff proposal for the ratemaking treatment of Other Major Maintenance Expense, which reflects a four-year period and other customer safeguard provisions would also be a reasonable alternative to items 6-7 above, and represent a good compromise between consumer interests and SCE&G's interests.

With the exception of specific issues addressed within the testimony and this brief, the Navy supports Staff's proposed adjustments as fair and reasonable and should be given more weight than the company's proposals. The preference for reliance on the company's business records does not extend to pro forma proposals and in this docket Staff's pro forma estimates are more balanced than the company's.